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**Testimony of
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before the
Subcommittee on Regulatory Affairs, House Committee on Government Reform
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Madam Chairman and members of the Subcommittee, on behalf of the American Stock Exchange (Amex or the Exchange), I would like to express our appreciation for the opportunity to comment on issues related to the implementation of the Sarbanes Oxley Act of 2002.

Against the backdrop of highly publicized failures of major companies, Congress sought to address public concerns and restore investor confidence in capital markets through the passage of the Sarbanes-Oxley legislation. In the years since the legislation was originally enacted, implementation of the broadly based regulatory initiative has been met with both praise and criticism. In connection with the implementation of Section 404, the Securities and Exchange Commission (SEC or the Commission) established the Public Company Accounting Oversight Board ("PCAOB") and created the Advisory Committee on Smaller Public Companies. Similar to the experience with other aspects of the Sarbanes-Oxley legislation, recently released recommendations of the Advisory Committee on Smaller Public Companies were met with praise by some and with criticism from others. The Advisory Committee recommended exempting most small and mid-cap companies from the full requirements of Section 404. On one side are those who say that such an exemption would potentially leave 80 percent of public companies exempt from Section 404 requirements. On the other side, supporters of the Advisory Committee recommendations point out that the companies affected are relatively small – comprising only about 6 percent of total market capitalization, thus 94 percent of the equity market capitalization would be fully subject to Section 404 requirements.¹

With so much at stake, we believe that it is worthwhile to examine the possibility of a compromise that aims to address concerns on both sides. Our testimony today includes an examination of alternative approaches to addressing the needs of policy makers, regulators, and small businesses.

¹ Final Report of the Advisory Committee on Smaller Public Companies to the Securities and Exchange Commission, April 23, 2006, page 7. <http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf>

The Amex has substantial experience with smaller public companies

As the only national stock exchange whose business focus is on listing small and mid-sized companies, we feel uniquely qualified to voice concerns on the effects of Sarbanes-Oxley (SOX) on this particular area of the capital market community.

While some of our 600 listed companies are large-cap companies, the majority has small and mid-capitalization between \$50 million and \$1 billion. Any regulatory system that discourages such companies from participating in the public markets is of vital importance to our Exchange and our listed companies.

Sarbanes-Oxley and the rules associated with it were established in 2002 to improve corporate governance and internal controls after a wave of accounting scandals that left a black eye on corporate America. These new regulations, however, made no distinction between a fifty billion-dollar large-cap company and a \$75 million small-cap company. The law's failure to recognize the differences makes it extremely difficult for smaller companies to compete and grow in this current regulatory environment.

The lack of differentiation also places Amex and other U.S. exchanges at a steep competitive disadvantage in listing foreign based companies who instead chooses to avoid U.S. capital markets.

Ownership and investor interest is different for small companies

Investors need to be protected from the corporate scandals that became the impetus for Sarbanes-Oxley, but context is important. The large scandals that led to passage of Sarbanes-Oxley involved large companies or, like Enron, companies that pretended to be large companies. Large-scale investor concerns that were implicated in the Enron scandal typically are not pervasive in the case of small and micro-cap stocks, which, from looking at a sample of Amex-listed companies, frequently have substantial ownership in common between the entrepreneurs and their families who founded the company and public shareholders. The owners are not out to cheat themselves. The exchange's regulation of our listing requirements provides significant investor protection.

Regulators have yet to determine how best to address these corporate governance issues without disadvantaging smaller companies that lack the same resources as larger companies. Key problems that confront smaller companies involve Section 404 of Sarbanes Oxley, which requires designing, documenting and auditing of financial controls. ***Neither the PCAOB nor the accounting industry have adequately defined what it means-or what is necessary-to comply. This lack of clarity has increased costs so that the auditing firms "leave no stone unturned" no matter how remote or immaterial the issue may be.***

Complaints by smaller companies about inconsistency and lack of a uniform approach by accounting firms are supported by recent inspection reports posted on PCAOB's website.² On June 8, a series of 14 inspection reports were added to the reports

² http://www.pcaobus.org/Inspections/Public_Reports/index.aspx

listed on the website, PCAOB found deficiencies in all 14 companies in over twenty five categories ranging from valuation of an intangible asset to revenue and testing for existence and completeness of a company's outstanding shares. The widespread problems with the accounting firms as reported by the PCAOB give support to those concerned over the lack of regulatory consistency and clarity.

This lack of regulatory clarity also allows foreign exchanges to arbitrarily "fill in the blanks" of Section 404 compliance as they cross the U.S. and market their own major benefit – avoidance of Sarbanes Oxley.

The SEC has taken steps to address these issues by creating an advisory committee to examine the impact of Sarbanes-Oxley and other aspects of the federal securities laws on smaller companies. In April, the Advisory Committee on Smaller Public Companies transmitted their recommendations, developed over the previous year with significant public input. As one of those invited to participate in one of several public hearings conducted by the Advisory Committee, the Exchange reached out to numerous Amex-listed companies - who represent the living concerns of this advisory committee - about their thoughts and recommendations on the "one size fits all" approach of SOX Section 404.

The Amex sought input from our market participants, and we received detailed and passionate feedback from the heads of listed companies that were not complaints about the SEC but thoughtful insights on how to implement securities regulations to accommodate the issues and challenges of smaller companies. The point that the chief executives of our listed companies wanted the SEC and the PCAOB to understand and acknowledge is that when it comes to regulating corporate governance, different standards need to apply to companies with small market capitalization or minimal revenues.

The most common concerns that our CEOs voiced on Section 404 related to: 1) duplicative or prohibitive costs, 2) the adverse impact on a company's relationship with its auditors, and 3) the requirement of segregation of duties within a small company.

Regarding costs to be compliant with Section 404, some of our companies told us that their auditing fees have tripled or quadrupled since the regulation was imposed. A \$1 million auditing bill may be a drop in the bucket for a company with a \$10 billion market capitalization, but for a \$100 million dollar company that may have little or no revenue while awaiting FDA approval for a promising drug, or U.S. Patent Office approval for a new medical device, that is a significant amount of money.

Smaller companies consider overseas exchanges – Loss of business and regulatory oversight

Uncertainty over the extent to which Section 404 requirement will be applied has led to some smaller companies' consideration of utilizing non-U.S. capital markets. A May 8 article in Forbes magazine describes how concerns on Section 404 have led

smaller companies to look outside the U.S. for capital.³ The article discusses recent decisions by smaller companies to eschew U.S. capital markets in favor of listing on foreign-based exchanges. In describing efforts by one exchange, the following passage is telling:

"Other foreign markets have made gains, too, but London's AIM has been particularly persistent. In recent months AIM executives have hosted more than 30 pitchfests (sic) in the U.S., wooing investors in New York, Boston, Silicon Valley, Atlanta, Denver and Minneapolis. "It's not particularly subtle," says Graham Dallas, a senior international development manager at the London Stock Exchange. "We tell them there is an opportunity-rich landscape for them to exploit. The rules are quite simple and short. Otherwise, companies will spend all their time on compliance and not enough time building wealth." (IBID)

The Financial Times in an opinion piece dated March 27, 2006 lauded London's mix of "measured regulation" and "pro-competition orientation" as the engine for the growth of London's role as a financial center. Sarbanes Oxley was labeled in this piece simply as one of "others' mistakes."

In a recent trip to Tel Aviv, which is a hot bed of entrepreneurship, particularly in health science and technology, I witnessed the AIM marketplace aggressively marketing its lesser requirements, and lower costs, of governance contrasted with the United States. However, in exploring in some depth the specific concerns that many of these companies have, I discovered that most take pride in their internal controls, and the integrity of financial reporting, so were not scared by the concepts. On the other hand, the lack of specific, clearly defined standards does frighten potential entrants to the U.S. markets, as does the annual cost of certification. I believe that some relatively small tweaking of rules, as well as clearly defined standards that provide guidance and safe harbors can go a long way to improving the problems with the statute's application and perception.

Recently, the Exchange has experienced firsthand the impact of Sarbanes Oxley on smaller companies seeking equity capital. Last month, the Exchange received a letter from one of our listed companies advising of its decision to delist its stock from trading on the Amex.

In a letter to the Exchange informing us of the company's decision, the executive explained the decision as related to the U.S. regulatory environment, and stressed that the company's stock will continue be traded on the Toronto Stock Exchange;

"In support of this request to voluntarily delist [company name redacted] shares from AMEX, we note that the shares of [company name redacted] of record are held by less than 300 persons worldwide and that the primary trading market for [company name redacted] shares is the Toronto Stock Exchange. We further note that the Board of Directors of [company name redacted] has determined that the costs and burdens of maintaining a listing on AMEX and of complying with U.S. securities regulatory requirements is not a cost effective

³ "London Calling; Small companies skip the U.S., go public overseas," Forbes, Volume 177 Issue 10, May 8, 2006. <http://www.forbes.com/forbes/2006/0508/051.html>

application of the [company name redacted] financial and managerial resources as they outweigh the benefits to [company name redacted] and its shareholders.”

Another example of the impact of Sarbanes Oxley occurred in conjunction with a European marketing effort in which I participated, the objective of which was to seek dual listing by European companies on the Amex. The following is the text from an email response to our invitation sent out in late May:

“My interest in the AMEX was as a potential venue for a dual listing. I have just mentioned this possibility to our in house counsel and he went very red. It would appear that Sarbanes Oxley has completely put paid (sic) **["put an end to"]** to any interest we may have had in such a scheme, so I am afraid to say that I feel there would be no point in my attending the dinner next week, and I will therefore be declining Mr Wolkoff's kind invitation.” (Name withheld)

Obviously, U.S. exchanges that cater to smaller companies seeking capital by going public should be concerned by these recent events. However, those with a desire for a stronger regulatory approach should be concerned as well, for with the movement to non-U.S. exchanges, regulatory oversight is lost as well. The Amex believes in a having a strong regulatory environment, although one that allows competition to thrive. Further, the Amex believes that this position is consistent with the '34 Act.

PCAOB spurns the Advisory Committee recommendations – but is there a compromise position?

Following a joint SEC-PCAOB roundtable discussion held on May 10 to discuss implementation issues surrounding Section 404, the SEC and the PCAOB disappointed many small businesses by largely ignoring the recommendations of the Advisory Committee on Smaller Public Companies.^{4,5} In public statements issued following the roundtable, both bodies said that though they would attempt to address implementation issues, that all companies would be expected to be in compliance with Section 404 requirements beginning with fiscal years starting on or after December 16, 2006.

Most industry experts agree that the legislation's intent is laudable, in that it punishes fraudulent behavior and demands executive accountability. However, regulators must take care to avoid the pitfall of imposing a uniform doctrine on small and mid-sized companies that are in the formative stages of their growth. Development stage companies with little or no revenue generally have less complicated financial statements (e.g., because they do not have revenue recognition issues) requiring less rigid internal controls.

The Advisory Committee on Smaller Public Companies report (op. cit.) recommended that the SEC give full Section 404 exemptive relief to some microcap and smallcap

⁴ No Sarbanes-Oxley break for small companies. Reuters, May 17, 2006 <http://www.msnbc.msn.com/id/12839694/>

⁵ SEC Announces Next Steps for Sarbanes Oxley Implementation. SEC Digest May 17, 2006, Issue 2006-95. <http://www.sec.gov/news/digest/2006/dig051706.txt>

companies that comply with enhanced corporate governance provisions. The proposed exemption would apply to:

- microcap companies--companies with equity capitalizations below approximately \$128 million--that have less than \$125 million in annual revenue; and
- small cap companies--companies with equity capitalizations between approximately \$128 million and \$787 million--that have less than \$10 million in annual product revenue.

The committee also recommended that SEC should grant exemptive relief from external auditor involvement in the Section 404 process to smallcap companies with less than \$250 million but more than \$10 million in annual revenues, and microcap companies with between \$125 and \$250 million in annual revenues, subject to their compliance with the same corporate governance standards as the microcap firms.

The Advisory Committee report generated comments, both critical and supportive. Among other objections to the committee proposal for exemption from certain requirements of Sarbanes-Oxley Section 404 for smaller companies, was that 80 percent of public companies would be exempted in some way from compliance.⁶ Supporters of the Committee's recommendations noted, however, that under the recommendations, 94 percent of the U.S. equity market capitalization would be fully covered by Section 404 requirements.

Is there a "middle ground?"

We support the conclusions of the Advisory Committee, and believe they represent a sound balancing of interests between regulation and economic growth. In its current form, Sarbanes Oxley reminds one of calls to increase the minimum wage to \$15 an hour: laudable, ethical, but a recipe to move jobs to less laudable jurisdictions. One Israeli woman had it precisely right when she opined that "Sarbanes Oxley is too good!"

We also believe that something must be done even if the full range of the Advisory Committee's opinions are not followed, either by the SEC and the PCAOB, or if a legislative solution is not enacted. In an effort to obtain the bare bones of some relief, given the polarization of views about large-scale exemptions, I believe that compromise might benefit the process.

Recent statements by the SEC and the PCAOB cited earlier give little relief to smaller companies concerned with the significant burdens associated with full compliance with the provisions of Section 404. However, in response to growing concerns of small businesses, Congressman Tom Feeney introduced H.R. 5405⁷, a bill that modifies Section 404 of Sarbanes Oxley by making compliance voluntary for companies in the following categories:

⁶ Letter from Damon Silvers, Associate General Counsel, AFL-CIO to Christopher Cox and William Gradison. Mar. 27, 2006, <http://www.sec.gov/rules/other/265-23/aflcio032706.pdf>

⁷ <http://thomas.loc.gov/cgi-bin/query/z?c109:H.R.5405>:

- Total market capitalization for the relevant reporting period of less than \$700 million
- Total product revenue for that reporting period of less than \$125 million
- The issuer has fewer than 1,500 record beneficial holders
- The issuer has been subject to the requirements of sections 13(a) or 15(d) of the Securities Exchange Act of 1934 for a period of less than twelve calendar months; or
- The issuer has not filed, and was not required to file, an annual report pursuant to section 13(a) or 15(d) of the Securities Exchange Act of 1934.

The legislation currently has 22 cosponsors, including the Chairman of this subcommittee. The Senate companion bill, S. 2824, introduced by Senator James DeMint has 8 co sponsors. The legislation represents some of the core recommendations of the SEC Advisory Committee on Smaller Public Companies (op. cit.) and is fully deserving of consideration.

Prior to the introduction of H.R. 5405, the Exchange offered suggestions on possible alternatives in a letter to the SEC and the PCAOB for consideration during their May 10 “roundtable” discussion of Section 404 issues⁸. We proposed that companies with \$200 million in market capitalization and below should be allowed to choose non-compliance with Section 404, but that such a decision must be publicly disclosed, along with a statement as to why the company has chosen not to comply and whether (and if so to what extent) it has taken alternative voluntary steps to monitor its internal controls. Above that level, Section 404 compliance must be certified and then recertified every two to three years, not annually, based on capital. For example, compliance might need to be certified every two years for those companies with a market capitalization above \$500 million but below \$1 billion, and every three years for companies below \$500 million, but above \$200 million. Full compliance would be expected for those companies over \$1 billion in capitalization. This approach gives flexibility to smaller companies, allows for investors to be informed, and provides for a path of growth that ultimately leads to full compliance with Section 404 requirements.

I believe that failure to distinguish the fundamental structural and financial differences between small companies seeking access to U.S. capital markets and larger well financed and capitalized companies in the application of Section 404 requirements would be a mistake that could be detrimental to small businesses in particular and to the U.S. economy in general. Further, the SEC and the PCAOB must be directed to apply clear, consistent guidelines and definitions to what it expects in Section 404 compliance. Not all business are run by CPAs or corporate attorneys. Applying Section 404 in a “one size fits all” manner without regard for the disproportionate cost and regulatory burden on smaller companies, as we have already witnessed in examples cited earlier, could well lead those companies to move to overseas capital

⁸ Letter from Neal L. Wolkoff to SEC Chairman Christopher Cox and William Gradison, Acting Chairman of the PCAOB, May 8, 2006.

markets, resulting in both a loss of business for U.S capital markets, and, perhaps just as important, loss of any regulatory oversight that might otherwise be in place.

Global exchange mergers pose additional policy and regulatory questions

Mergers of exchanges, such as the recently proposed merger of the New York Stock Exchange (NYSE) and Euronext have the potential to pose additional problems for U.S capital markets, policy makers, and regulators. Already we are witnessing efforts by European, Asian, and other non-U.S. based exchanges to convince U.S. companies to eschew the U.S. capital marketplace in favor of foreign markets. Depending on the final structure of the NYSE-Euronext marketplace, the formerly domestic NYSE could well be in a position to benefit from companies' concerns over Sarbanes Oxley by accessing its European regulated arm, Euronext. In the absence of agreement amongst the respective regulatory bodies, multinational exchanges could attract U.S. companies seeking to avoid the expense and regulatory overhead of Sarbanes Oxley. Such a development would further complicate the current situation, and would doubtless work to the detriment of domestic capital markets without a non-U.S. subsidiary. Potentially, smaller companies would increasingly choose overseas capital markets for initial public offerings, and, arguably, it would be difficult to get them to return to the U.S. capital marketplace when they are of a size to be able to "afford" Sarbanes Oxley. Such a scenario would operate as a disincentive to US listing and SEC registration resulting in a significant regulatory gap.

We also believe that careful examination of the issues faced by smaller companies in complying with Section 404 as outlined in the recommendations of the Advisory Committee on Smaller Public Companies (op. cit.), could lead to a compromise that would not unduly burden small business, yet would provide investors with confidence. Recent actions and statements by the SEC and the PCAOB indicate inflexibility and, we believe, a failure to fully realize and appreciate the burdens placed on smaller companies by Section 404. The "one size fits all" approach is taken without regard to the impact of the cost and regulatory burden on the small but important segment of the capital marketplace that smaller companies represent. We have offered suggestions to an alternative approach that preserves the framework of Section 404, but allows for a more flexible approach to smaller companies. However, the urgency in clarifying the application of Section 404 is great. The legislative approach embodied in H.R. 5405, and Senate companion bill S. 2824 represents a realistic approach to the need to insure transparency and accountability without the stifling effect of a "one size fits all" approach to implementation of Sarbanes Oxley, and, if no other negotiated resolution is feasible, the legislative route should be pursued.

The flight of smaller companies seeking to avoid the expense of Sarbanes Oxley could ultimately be a "Marshall Plan" for overseas exchanges. Though unintended, the result of such a movement would certainly work to the detriment of U.S. capital markets, the U.S. economy, and to the oversight ability of U.S. regulators.

Thank you for the opportunity to provide our experience and input to this important issue. I will be happy to answer any questions that you may have.